Dodd-Frank And The Impact On Internal Audit

The Path Forward For Energy Companies

The Institute Of Internal Auditors – Houston Chapter

Paul Campbell

Deloitte & Touche LLP

November 5, 2012
Table of contents

1. Overview of Dodd-Frank Act Title VII
2. Classification and potential impact on an organization
3. Major requirements, timeline updates and recent changes
4. Where the energy industry is struggling
5. What companies and internal audit should consider doing now
6. Specific internal audit considerations
7. Questions & Answers
Paul Campbell

Principal, Deloitte & Touche LLP
Email: paulcampbell@deloitte.com  Office: 713.982.4156  Mobile: 713.503.6993

Paul is a leader in Deloitte’s Energy Risk practice, providing services to the energy industry and the federal government. With more than 20 years of experience, he also leads specialists from a group of approximately 200 professionals solely dedicated to providing services related to risk strategy, regulatory compliance, credit, climate change, quantitative analytics, technology, business process and operations and risk accounting to energy companies.

Paul has worked with some of the largest companies in North America on transformation efforts related to the underlying infrastructure, systems, processes and technologies for new organizations as well mature organizations focused on significantly changing operations with thorough programs of change or responding to regulatory directives. This includes helping to design, develop, select and implement energy trading and risk management systems, as well as those to support compliance with derivative accounting guidance. This includes leading all energy related efforts for regulatory compliance and Dodd-Frank.

He has led numerous risk assessments of front, middle and back office operations and worked extensively on risk management issues related to new business strategies; including the resulting process, technology and accounting change implementations. These assessments have often then led to the development of a program of activities related improvements in the risk and trading processes.

His client service work also includes developing of end user energy management strategies, due diligence analyses, bankruptcy work, and significant litigation support efforts regarding portfolio valuation, internal investigations and support to external counsel in trading and risk management matters. Paul also has significant experience speaking and providing training to both internal and external audiences. Prior to joining Deloitte, Paul worked for 4 years as a regulatory economist for the Maryland Public Service Commission and then worked for several energy trading companies moving to Houston.

- BS, Physics – The George Washington University
- BA, Political Communications – The George Washington University
Overview of Dodd-Frank Act Title VII
<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>API</td>
<td>Application Programming Interface</td>
</tr>
<tr>
<td>BCS</td>
<td>Business Conduct Standards</td>
</tr>
<tr>
<td>CFR</td>
<td>Code of Federal Regulations</td>
</tr>
<tr>
<td>CFTC</td>
<td>Commodity Futures Trading Commission</td>
</tr>
<tr>
<td>CPO</td>
<td>Commodity Pool Operators</td>
</tr>
<tr>
<td>CRFC</td>
<td>Core Reference Futures Contract</td>
</tr>
<tr>
<td>DRR</td>
<td>Data, Recordkeeping and Reporting</td>
</tr>
<tr>
<td>DCM</td>
<td>Designated Contract Market</td>
</tr>
<tr>
<td>DCO</td>
<td>Derivative Clearing Organization</td>
</tr>
<tr>
<td>ECP</td>
<td>Eligible Contract Participant</td>
</tr>
<tr>
<td>ETRM</td>
<td>Energy Trading Risk Management</td>
</tr>
<tr>
<td>FAS</td>
<td>Financial Accounting Standard</td>
</tr>
<tr>
<td>FTR</td>
<td>Financial Transmission Rights</td>
</tr>
<tr>
<td>ISO</td>
<td>Independent System Operator</td>
</tr>
<tr>
<td>LEI</td>
<td>Legal Entity Identifier</td>
</tr>
<tr>
<td>LTR</td>
<td>Large Trader Reporting</td>
</tr>
<tr>
<td>MSP</td>
<td>Major Swap Participant</td>
</tr>
<tr>
<td>NFA</td>
<td>National Futures Association</td>
</tr>
<tr>
<td>Nons</td>
<td>Non SD / Non MSP</td>
</tr>
<tr>
<td>OTC</td>
<td>Over the Counter</td>
</tr>
<tr>
<td>PLR</td>
<td>Position Limits Reporting</td>
</tr>
<tr>
<td>RTO</td>
<td>Regional Transmission Organization</td>
</tr>
<tr>
<td>RTR</td>
<td>Real Time Reporting</td>
</tr>
<tr>
<td>SD</td>
<td>Swap Dealer</td>
</tr>
<tr>
<td>SDR</td>
<td>Swap Data Repository</td>
</tr>
<tr>
<td>SEF</td>
<td>Swap Execution Facility</td>
</tr>
<tr>
<td>SPV</td>
<td>Special Purpose Vehicle</td>
</tr>
<tr>
<td>UCI</td>
<td>Unique Counterparty Identifier</td>
</tr>
<tr>
<td>UPI</td>
<td>Universal Product Identifier</td>
</tr>
<tr>
<td>USI</td>
<td>Unique Swap Identifier</td>
</tr>
</tbody>
</table>
Dodd-Frank Act\(^1\): Background and perspective

### Dodd-Frank Act

Title VII includes key provisions for the energy industry with clear consideration of the Commodity Futures Modernization Act of 2000 that exempt many over-the-counter energy trades from federal regulation.

### Controls

- CFTC (Commodity Futures Trading Commission)
- Swap Data Repositories, Swap Execution Facilities
- Major Swap Participants, Swap Dealers, End Users
- Reporting requirements (execution and record keeping)
- Compliance (Chief Compliance Officer)
- Portfolio valuations and reconciliations
- Push from OTC to Derivative Clearing Organizations
- From un-cleared to cleared transactions
- Position limits (TBD)
- Capital requirements

### Systemic Risk in Financial Markets associated with derivatives trading

- Counterparty Risk Management

### 1. Legislative Phase

- Act signed into law July 2010
- Many rule making responsibilities delegated to the SEC and the CFTC
- Law passed as response to concerns over inadequate oversight of financial and commodity markets

### 2. Regulatory Phase

- CFTC aimed for Dec 2011 for final rules (numerous delays have occurred)
- 30+ rule making processes initiated
- Rule making activities address new market structures and functions, changing definitions, new processes and more oversight
- Ongoing advocacy process

### 3. Commercial Phase

- Dealing with uncertainty over final rules and implementation timelines
- Evaluating readiness to handle proposed rules
- Evaluating financial impacts related to credit and collateral as well as potential capital investment needs
- Implementing changes to people, processes, technology, and governance

---

Energy industry and Non-SD application

<table>
<thead>
<tr>
<th>All of Dodd-Frank</th>
<th>Title VII - Swap Dealers / Major Swap Participants</th>
<th>Non Swap Dealers / Non Major Swap Participants</th>
</tr>
</thead>
</table>
| Dodd-Frank Wall Street Reform and Consumer Protection Act (All Industries) | Title VII – Wall Street Transparency and Accountability (regulates OTC Swaps)  
- For SDs, 1,000s of applicable rules | Title VII as applicable to Non-SD’s / Non-MSPs  
- Approximately 10 Potential RMAs, 100s of rules |
| - Categorized into 16 Titles  
- 10,000s of rules across 16 Titles | Applicable to Swap Dealers and Major Swap Participants  
- Registration  
- Large trader reporting  
- Business conduct rules  
- Margin and collateral management  
- Capital requirements and reporting  
- Risk management  
- Centralized clearing  
- Business continuity  
- Board and Senior Management have specific responsibility and personal liability  
- Designation of a Chief Compliance Officer  
- Annual Compliance Report | Applicable to All Eligible Contract Participants  
- Reporting  
- Record keeping  
- Compliance with exchange rules  
- Position limits (TBD)  
- Adherence to trade practices  
- End-use exception tracking and reporting  
- Margining (to the extent that trades are moved to clearing) |

Based on both qualitative and quantitative assessments.
Important points for energy companies

• The CFTC is working to finalize the rule-writing across the more than 30 different rule categories and is implementing a process balancing market disruption, cost and desired compliance status. The rules are generally comprehensive in nature across all commodities, IR and FX.

• Final rules yet to be published include:

  1. Margin and clearing requirements, including risk capital for Swap Dealers and MSP
  2. Position limits – unclear on regulatory path following Sep 22

• The CFTC has finalized most rules for compliance so the time to comply may vary depending on the category of company or asset. A staged approach is underway, in which effective dates for compliance vary by rule and become known as final rules are published. Current compliance timelines have ranged from 30 to 270 days.

• Most companies in the energy industry would describe themselves as having an internal group “maintaining awareness” of the rules, but often struggling with governance issues and how to plan or commit resources in the face of regulatory uncertainty

• Most companies have not addressed Sec. 1502 or 1504 as part of integrated planning.
• There are significant compliance requirements for almost any entity using swaps.
• There are specific concerns related to “special entities”.
• There is some chance for further delays or altering of regulations, but a clear desire by regulators to finalize rules quickly.
• Further uncertainty is likely.
Beyond Title VII - Other non-swap related provisions (Title XV) ¹

**Conflict Minerals Provision (Sec. 1502)**

- Finalized on August 22, 2012
- Companies that use conflict minerals from the Democratic Republic of the Congo and adjoining countries (“DRC”) that are “necessary to the functionality or production of a product manufactured by such person” must disclose annually public on their website, file a conflict mineral report to the SEC and annual report.
- The report will include description of measures of due diligence on the minerals source and chain of custody. Even if the minerals did not originate in the DRC the company would be required to maintain all documentation and issue the report.
- The SEC requires this report go through an independent private sector audit.
- The SEC realizes that there is some ambiguity as to whom the conflict mineral provision applies to. This would include many companies that do not have to report today.
- The SEC proposed rule would make amendments to Form 10-K, Form 20-F, and Form 40-F to add this information.
- Issuers must comply with the final rule for the calendar year beginning January 1, 2013 with the first reports due May 31, 2014

**Mine Safety (Sec. 1503)**

- Finalized on December 21, 2011
- Already in effect

¹ http://www.cftc.gov/LawRegulation/DoddFrankAct/index.htm
Beyond Title VII - Other non-swap related provisions (Title XV) ¹

Disclosure of Payments to Governments by Resource Extraction Issuers (Sec. 1504)

- Finalized on August 22, 2012
- Companies that extract or commercial development related to oil, natural gas, or minerals will need to file an annual report with SEC containing all the payment information to foreign governments at the project level. This report will include:
  - the total amount of payments, by category;
  - the currency used to make the payments;
  - the financial period in which the payments were made;
  - the business segment of the resource extraction issuer that made the payments;
  - the government that received the payments and the country in which the government is located; and
  - the project of the resource extraction issuer to which the payments relate

- The SEC proposed rule would make amendments to Form 10-K, Form 20-F, and Form 40-F to add this information.
- According to the rules the companies will need to include this information starting with an issuer’s annual report relating to any fiscal year beginning on or after September 30, 2013.

¹ http://www.cftc.gov/LawRegulation/DoddFrankAct/index.htm
The CFTC has issued final rules to provide whistleblower incentives and protection which became effective in September 2010

- Requires CFTC to pay awards to whistleblowers if provided information leads to successful enforcement of CFTC action.
  - Enforcement must produce monetary sanctions >$1 million.

- Certain criteria evaluated to determine issuance of reward:
  - Significance of information.
  - Degree of assistance in support of covered judicial or administrative action.
  - Public policy

- Certain government employees are ineligible to be granted whistleblower rewards

Classification and potential impact on an organization
Classification determines impact on an organization

How would an organization characterize its swap activity*?

- e.g., hedging, asset optimization, speculation, potentially volume and intent.

Many of the reporting requirements fall upon the SD/MSP categories including reporting some information on behalf of the non-SD.

A common question: What is our comfort level as an organization relying upon others’ records and how do we want to validate this data?

*Strongly consider the role of external counsel in interpretation of rules.

Balance cost/benefit of registering as a Swap Dealer

Swap Dealer
Or
Major Swap Participant

- Registration
- Large trader reporting
- Business conduct rules
- Margin and collateral management
- Capital requirements and reporting
- Risk management
- Centralized clearing
- Business continuity
- Designation of a Chief Compliance Officer
- Annual Compliance Report

All Eligible Market Participants

- Reporting
- Record keeping
- Compliance with exchange rules
- Position limits
- Adherence to trade practices

*Factors for consideration: Benefits of registering vs. costs associated with such registration.

How would an organization characterize its swap activity*?

- e.g., hedging, asset optimization, speculation, potentially volume and intent.
Major requirements, timeline updates and recent changes
## Requirements applicable to all energy market participants

<table>
<thead>
<tr>
<th><strong>Basic Requirements</strong></th>
<th><strong>Details</strong></th>
</tr>
</thead>
</table>
| Reporting and Recordkeeping | • Retention and reporting of pre-execution, execution and post execution transaction information including orders, executions, oral and written communications; all indexed to the transaction  
• Data kept for the entire existence of a swap and five years after the swap’s termination or expiration.  
• Data must be *readily accessible*, and records must be retrievable by the recordkeeping counterparty within five business days. |
| Clearing | • All swaps must be cleared with limited exceptions |
| End-Use Exception To Clearing | • Process at time of transaction, with pre and post execution documentation and controls |
| Compliance with exchange rules | • Adherence to margin and collateral requirements for transactions executed on the exchange platforms |
| Adherence to trade practices | • Enhanced anti-manipulation authority requiring stronger self-surveillance along with anti-fraud protection. |
| **Position limits** | *Monitoring and reporting to be defined at a later date* |

There is a general misconception by non-financial entities that if “all we are doing is hedging (or asset optimization)” there are little or no compliance obligations. There currently is no broad “end-user exemption” or classification that would be applied.
Illustrative Dodd-Frank regulation timeline

- **SD/MSP:** Real-time Reporting & Data Recordkeeping (Other Commodity Swaps)
- **SD/MSP:** Real-time Reporting & Data Recordkeeping (Credit & IR Swaps)
- **Business Conduct Standards (Ext and Int)**
- **Swap Definition Published**
- **Real Time Reporting & Data Recordkeeping (Other Commodity Swaps)**
- **Swap Definition Finalized**
- **Remanded Position Limits Reporting**
- **Registration (Joint with NFA)**
- **Election Day**
- **Holidays**
- **Inauguration**
- **Non SD:** Real-time Reporting & Data Recordkeeping (All Asset Classes)
- **Estimated: Reporting End-User Exceptions**

Timeline:

- **May 12**
- **Jun 12**
- **Jul 12**
- **Aug 12**
- **Sep 12**
- **Oct 12**
- **Nov 12**
- **Dec 12**
- **Jan 13**
- **Feb 13**
- **Mar 13**
- **Apr 13**
- **May 13**
- **Jun 13**
- **Q3-Q4 2013**

- **Position Limits Reporting**
- **Estimated**
Where the energy industry is struggling
Key challenges summary

1. Scope of the impact across operations
2. Major uncertainty within regulatory environment
3. SD vs. non-SD classification (considering future operations and prices)
4. To clear or not to clear?
5. Potential hedging & end-user exception violations
6. Changes to contracts with counterparties, SDR, DCO, etc.
7. System enhancements
8. Corporate changes and decision making
9. Position limit compliance (TBD)

• Technical issues outstanding include
  – Bookouts
  – Notional value calculations
  – Swap definitions
Illustrative spectrum of industry reaction

How to move forward when faced with uncertainty?

1. Deal with this as you would any other project.
2. Act on the known and plan for the unknown – assess the potential impact of change to both.
3. **Balance the cost of waiting and higher potential cost if significant external resources are called in at the last minute.**
4. Always have a plan!
Illustrative spectrum of IA responsibility

- Wait and See
- Maintain Awareness
- Pro-Active

- Compliance / Project Execution
- Improve Efficiency / Add Value
What companies and internal audit should consider doing now
### What energy companies should consider doing now

1) **Deploying Cross-functional Dodd-Frank Implementation Team**
   - Engage risk, IT, compliance, accounting
   - Engage external counsel
   - Deploy a detailed plan, with estimates of resources/budget
   - Maintain awareness with Senior Management and Board of Directors

2) **Assessing Likelihood of Being an SD/MSP**
   - Detail all swap transactions
   - Confirm ability to identify and aggregate all needed data
   - Disaggregate cleared vs. non-cleared and hedges
   - Document counterparties and “special entities” dealing
   - Conduct rule by rule gap assessment

3) **Validating Recordkeeping Capabilities and Preparing for Real-Time and General Reporting Obligations**
   - Identify process changes across front, middle, and back office
   - Ensure all transition swap documentation is being maintained
   - Identify reporting counterparty
   - Develop the process for data verification and correction
   - Develop processes for capturing recordkeeping data elements

4) **Evaluating Technology Requirements and Capabilities**
   - Developing short term reporting solutions
   - Identifying immediate and long term changes to ETRM systems
   - Understanding and building connectivity with SEF/SDR

5) **Evaluating Potential Credit Implications**
   - Analyze liquidity impacts of margin posting for cleared swaps
   - For uncleared swaps, determine if counterparties are subject to CFTC or bank regulator margin rules
   - Determine if changes are needed to counterparty mix
   - Reviewing existing contract mix

6) **Preparing for Position Limit Obligations (TBD)**
   - Work with IT to document needed changes and functional requirements for tracking positions
   - Identify and aggregate positions across entities
   - Confirm internal notification capabilities exist
Illustrative long term Dodd-Frank compliance

Decisions required
- Allocation of resources for PMO and Implementation Support – internal/external
- Allocation of resources to change management – internal/external
- Impact across trading systems and/or reliance upon vendor solutions

Any approach should balance cost/resource requirements with regulatory risk tolerance and the ability to sustain a program
Illustrative Example of Customizable Deloitte Methodology

1. A library maintaining Dodd-Frank Title VII rules from CFTC and SEC
2. Interactive dashboards and report with drill-down capabilities
3. An interactive derivatives trade lifecycle mapped to relevant rules and identifying existing and new business processes impacted as a result of Dodd-Frank regulation
4. Heat Map to visualize the impact of Dodd-Frank Title VII regulations on different aspects of business – capital, liquidity, legal entity structure, compliance, information systems, workforce etc.
5. A Gap assessment to determine the compliance level, gaps and mitigating steps
6. A list of implementation activities and interdependencies to drive project planning for internal regulatory compliance programs
Illustrative Examples of QuickStart Methodology & Components

QuickStart may provide an out-of-the-box solution for assessment and implementation planning.

**Workplan**

The workplan will serve as a project plan and status dashboard. It can be customized to include specific project dates, milestones, and project team members.

**Templates**

The templates include customizable work products including rules/requirements inventories for each rulemaking area.

**Deliverables**

Deliverables include the Final Report outline, final presentation outline, gap assessment inventories, and implementation plans.

**Reference Guide**

The reference guide provides step-by-step instructions for project setup, population of templates, and how to produce the final deliverables.
Specific internal audit considerations
Audit Committee Considerations

While major responsibility lies with management and the Chief Compliance Officer, the implementation of these new rules should have thoughtful and ongoing oversight by the Audit Committee.

<table>
<thead>
<tr>
<th>Implementation</th>
<th>Financial Reporting</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ High level implementation plans, timeline and resourcing</td>
<td>▪ Impact of new external and internal reporting</td>
</tr>
<tr>
<td>▪ <em>Tone at the top</em> – management support for a culture of compliance</td>
<td>▪ Accounting policy changes affected by Dodd-Frank</td>
</tr>
<tr>
<td>▪ Risk management process</td>
<td>▪ Impact on earnings, equity, key ratios, performance indicators and compensations</td>
</tr>
<tr>
<td>▪ Role of Chief Compliance Officer and responsibilities</td>
<td>▪ Internal control certifications</td>
</tr>
<tr>
<td>▪ Impact on internal audit function and reporting</td>
<td>▪ Disclosure requirements</td>
</tr>
<tr>
<td>▪ Change management</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Impact on the board and board committees</th>
<th>Commercial and Operational Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Risks or changes relevant to board and its committees – level of commitment, internal controls and certifications</td>
<td>▪ Assessments of new controls</td>
</tr>
<tr>
<td>▪ Education and training of board members</td>
<td>▪ Improvement opportunities and controls rationalization</td>
</tr>
<tr>
<td>▪ Impact on risks and oversight responsibilities</td>
<td>▪ Impact on management reporting within the enterprise – planning, budgeting and forecasting</td>
</tr>
<tr>
<td>▪ How this implementation affects competitive position vs. competitors</td>
<td>▪ Communication to stakeholders on impact</td>
</tr>
</tbody>
</table>
Recap and opportunities

- Understand and confirm key stakeholders expectations of internal audit - including audit committee and other key committees
- Validate expectations around Dodd-Frank assurance requirements
- Become a key player in the risk management program
- Dodd-Frank Act will impact people, process, governance & controls and technology – be prepared to factor this into the internal audit planning process and resources
- Forward looking organizations see regulatory changes as an opportunity to simplify, standardize, and transform their current processes and culture
- Engage executives and board members in thoughtful consideration of potential risks
- Continue being a trusted advisor and don’t assume that Dodd-Frank is “going away”

Internal audit = Assurance, Insight, and Objectivity

1 Internal Audit Value Proposition. Insight: Delivering Value to Stakeholders 2011 by The Institute of Internal Auditors Research Foundation
Questions & Answers
About the Deloitte Center for Energy Solutions
The Deloitte Center for Energy Solutions provides a forum for innovation, thought leadership, groundbreaking research, and industry collaboration to help companies solve the most complex energy challenges.

Through the Center, Deloitte’s Energy & Resources Group leads the debate on critical topics on the minds of executives — from legislative and regulatory policy, to operational efficiency, to sustainable and profitable growth. We provide comprehensive solutions through a global network of specialists and thought leaders.

With locations in Houston and Washington, D.C., the Deloitte Center for Energy Solutions offers interaction through seminars, roundtables and other forms of engagement, where established and growing companies can come together to learn, discuss and debate.

www.deloitte.com/energysolutions

About Deloitte
Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

This presentation contains general information only and Deloitte is not, by means of this presentation, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This presentation is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte, its affiliates, and related entities shall not be responsible for any loss sustained by any person who relies on this presentation.

Copyright © 2012 Deloitte Development LLC. All rights reserved.
Member of Deloitte Touche Tohmatsu Limited